

ECONOMIC VIEWPOINT



Rate Hikes Are Starting to Have a Slight Impact on Canadian Households

Key interest rates have already gone up 100 basis points in the last year. However, the rise has only partially passed through to loans to Canadians: the average effective rate on their loans rose only 32 basis points between the second quarter of 2017 and the second quarter of 2018. Despite this fairly small increase, debt service is already near its historic high. Key interest rate increases should start to have a stronger impact on rates for consumer and home loans in the coming months, especially as further key rate increases are likely to be imposed between now and 2020. Under these conditions, debt service will soon set new historic records and, among other things, trigger slower growth in household spending. A great deal of uncertainty surrounds this, which is why key interest rates will be increased very slowly.

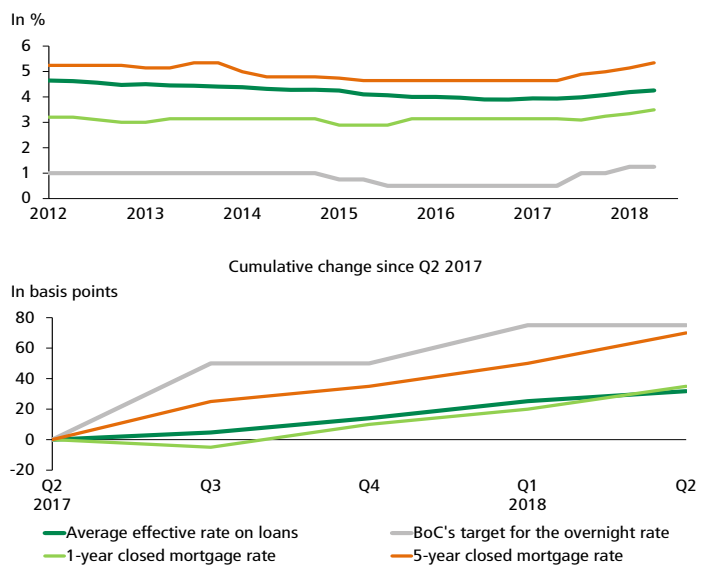
Just over a year ago, the Bank of Canada (BoC) began to bring its key interest rates up gradually. However, the increases have not had much tangible impact on Canada's economy so far. Statistics Canada recently released the second-quarter figures for the national balance sheet, and the household debt ratio went up again. A detailed analysis of national balance sheet results is even more revealing.

Household credit market debt totalled \$2,166B (annualized) in the second quarter of 2018. Mortgages accounted for 65% of that amount, while consumer credit weighed in at 30%. Other types of loans represented just 5%. The interest paid on these loans totalled \$92B in the second quarter.

Increase in Key Interest Rates Is Being Transmitted Slowly

Using this data, we can calculate an average effective interest rate on Canadians' total borrowings. According to our estimates, it was 4.25% in the second quarter of 2018. In comparison, the rate was just 3.94% in the second quarter of 2017, just before the BoC started raising its key interest rates, a difference of 32 basis points. During the same period, key rates went up 75 basis points,¹ while the closed mortgage rates posted by financial institutions rose 30 points for 1-year terms and 70 points for 5-year terms (graph 1). The average effective rate

GRAPH 1
Canadians' loans do not yet fully reflect the key rate increases



BoC: Bank of Canada
Sources: Statistics Canada, Datastream and Desjardins, Economic Studies

¹ The 25 basis point increase imposed in July was not included in this calculation, as it fell in the third quarter.

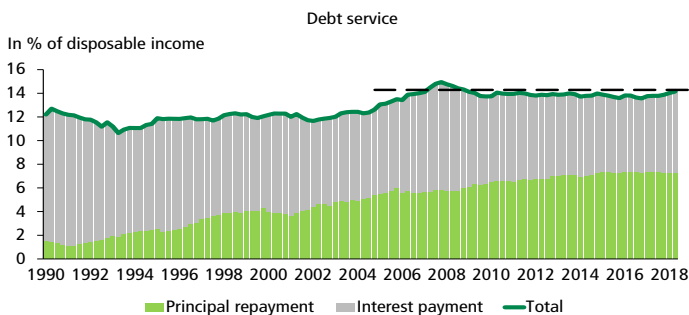
François Dupuis, Vice-President and Chief Economist • Benoit P. Durocher, Senior Economist

Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

did not go up as much as most other rates because the rates on many loans are fixed for several months or even years. The higher interest rate only goes into effect once the term has elapsed and the loan is renewed. In other words, the key interest rate increases already imposed will have a growing impact over time.

Although small thus far, the slight increase in the effective interest rate has still had an impact on debt service (repayments of principal as well as interest payments). Expressed as a ratio of disposable income, debt service climbed to 14.15% in the second quarter of 2018, not far off its record peak of 14.94% (graph 2). If loans outstanding and disposable income remain at current levels, the average effective rate would only have to go up another 50 basis points for debt service to hit a record high. Given that the key rate increases already imposed have not yet been fully incorporated into the average effective rate, it is only a matter of time before much of the gap is eliminated.

GRAPH 2
Debt service is nearing its record high



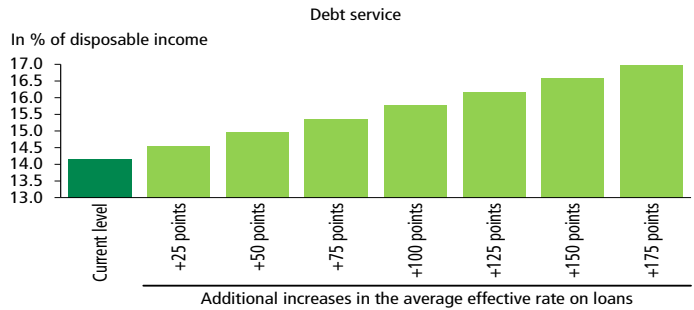
Sources: Statistics Canada and Desjardins, Economic Studies

However, there is every indication that key interest rates will rise further. In addition to last July's increase, another increase is likely in October. It could be followed by three further increases by 2020, bringing the total increase since the end of Q2 2018 to an additional 125 basis points. Clearly, debt service will hit a new record high when all of the rate increases have completely passed through to the average effective rate on household loans (graph 3).

Households Will Adjust

It is hard to predict with any accuracy how households will respond to these rate increases. As the BoC has stated a number of times, due to their high debt loads, households are likely more sensitive to interest rate increases now than they were in the past. How much more? Once the average effective rate on household loans has fully incorporated all of the previous interest rate increases, and those yet to come, the amount of interest paid will be much higher. If outstanding debt stays at this level, the rate increases could ultimately represent an additional

GRAPH 3
Impact of an increase in the average effective rate on debt service*

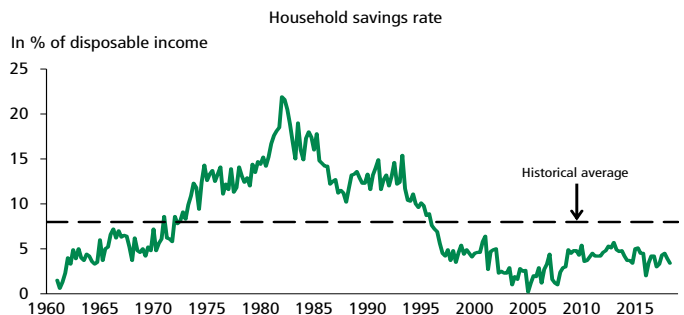


* Keeping outstanding debt and disposable income at Q2 2018 levels.
Sources: Statistics Canada and Desjardins, Economic Studies

increase of about 40% in interest payments. This represents an increase of about 2.8% in relation to households' disposable income. These figures are presented for illustrative purposes, of course. Disposable household income will keep rising in the coming quarters; outstanding household debt will no doubt increase as well.

One adjustment that households could make is to modify their saving habits. According to the figures in the national accounts, Canadians saved \$42B (annualized) in the second quarter of 2018. This amount corresponds to the difference between disposable income (\$1,294B factoring in the variation in pension entitlements) and consumer spending (\$1,252B). The savings rate, i.e. savings in relation to disposable income, was 3.4% in the second quarter. This is fairly low, historically speaking (graph 4). That said, the savings rate has been lower in the past, indicating that households have some leeway; they can no doubt reduce the amount of money they save slightly to deal with the financial obligations arising from the higher interest rates.

GRAPH 4
The household savings rate is already fairly low, historically speaking



Sources: Statistics Canada and Desjardins, Economic Studies

The other potential adjustment has to do with consumer spending, of course. Note that the disposable income measurement used in these calculations subtracts the interest paid on Canadians' loans. If interest payments go up due to the rise in interest rates, disposable income will go down accordingly, all other things being equal. To adjust, many households could decide to cut back on consumer spending. That scenario would obviously have the greatest impact on the growth of the Canadian economy.

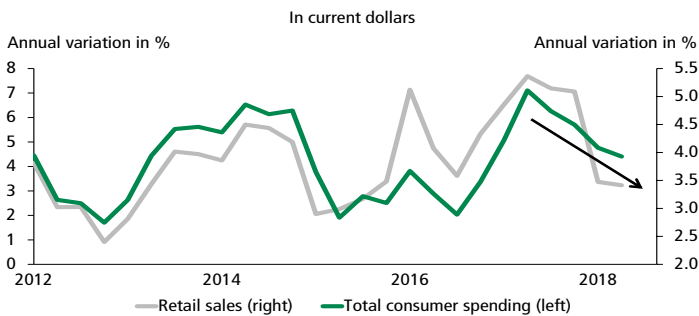
That being said, the results for consumer spending are fairly good for now. The annual growth in the value of consumer spending was 3.9% in the second quarter of 2018, similar to that in disposable income. Signs of flagging are showing, however, as the annual increase in consumer spending was 5.1% in the spring of 2017. The same can be seen for the value of retail sales (graph 5). In particular, growth is less robust for certain durable goods that are more sensitive to interest rate fluctuations, like motor vehicles and furniture.

The Key Lies in the Extent

The scope and speed of households' ability to adjust to higher interest rates remain highly uncertain. This means that key interest rates must be brought up very slowly. It also seems clear that key interest rates will not have been raised as much as they were in recent monetary tightening. Monetary authorities have already opened the door to another increase in the overnight rate when they meet next in October. It should then be several months before another increase is imposed, likely in the spring of 2019.

Benoit P. Durocher, Senior Economist

GRAPH 5
Consumer spending is growing more slowly



Sources: Statistics Canada and Desjardins, Economic Studies

Clearly, the impacts on Canadians of the gradual rise in interest rates are only beginning. The additional key rate increases forecast for the coming quarters, combined with greater pass-through of past increases, will substantially inflate debt service in the coming quarters. While cutting back on saving could provide somewhat of a cushion, consumers will have to adjust their spending accordingly. The impact on individual households will vary significantly, depending on how much debt they have. In general, young middle-class households could be particularly hard hit by the negative impacts of rising interest rates.

Thankfully, Canadians are now enjoying a lively employment market, with some labour shortages. This could put upward pressure on wages, which would also offset some of the adverse impacts of rising debt service. In the end, our latest economic scenario still calls for growth in consumer spending to wane in 2018, 2019 and 2020, which could slow economic growth somewhat.